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SBC Communications Inc.
1401 I Street, N.W.
Suite 1100
Washington, DC 20005

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

Ms. Dorothy Attwood
Chief
Common Carrier Bureau
Federal Communications Commission
445 12th Street, SW 5th Floor
Washington, D.C. 20554

Re: Ex Parte Presentation
Inter-Carrier Compensation for ISP Bound Traffic
CC Docket 99-68

Dear Ms. Attwood:

Attached is a paper that discusses how reciprocal compensation for Internet and local traffic distorts competition and investment in telecommunications markets and why a bill and keep regime would eliminate these distortions.

If you have any questions about these matters, please do not hesitate to contact us.

Yours truly,

Robert T. Blau
Vice President - Executive and Federal
Regulatory Affairs
BellSouth Corporation
1133 21st Street, NW
Suite 900
Washington, D.C. 20036

Melissa Newman
Vice President - Regulatory Affairs
Qwest
1020 19th Street, NW
Suite 700
Washington, D.C. 20036

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List ABCDE

Priscilla Hill-Ardoin
Senior Vice President - Federal Regulatory
SBC Telecommunications, Inc.
1401 Eye Street, NW
Suite 1100
Washington, D.C. 20005

Susanne Guyer
Vice President - Federal Regulatory
Policy & Planning
Verizon
1850 M Street, NW
Suite 1200
Washington, D.C. 20036

cc: Jane Jackson
Tamara Preiss
Adam Chaneub
Rodney McDonald

Attachment

A BILL AND KEEP SYSTEM FOR ISP-BOUND AND LOCAL TRAFFIC IS IN THE PUBLIC INTEREST AND SHOULD BE IMPLEMENTED WITHOUT DELAY

A. Reciprocal Compensation Displaces Market Forces as a Driver of CLEC Business Decisions.

1. It Encourages CLECs to Target Customers Who Terminate More Traffic Than They Originate.

In general, the cost of performing originating switching on a call exceeds the cost of terminating switching because the call set-up function is performed only at the originating end of the call. But in a reciprocal compensation regime, carriers are more generously compensated for call termination than for call origination. Specifically, while both carriers generally receive flat-rated local service revenues from their respective customers, the carrier that originates a call must pay reciprocal compensation to the carrier that terminates the call. The reciprocal compensation that must be paid by the carrier that originates the call offsets (and can even exceed) the flat-rated basic service revenues it receives from its customer. In contrast, the reciprocal compensation received by a carrier that terminates the call adds to the overall revenues that carrier receives from its customer – leaving it with net revenues consisting of its basic local service fees plus the reciprocal compensation it receives. As a result, it is more profitable for CLECs to target customers who terminate more traffic than they originate, and the greater the customer's imbalance, the more attractive is the customer to the CLEC. Conversely, the more traffic a customer originates relative to the amount of traffic it terminates, the less attractive is the customer.

The distorting effects of reciprocal compensation are most acute with respect to customers, such as ISPs, who receive large amounts of inbound traffic but make few or no calls. Not only do carriers receive potentially enormous reciprocal compensation payments to supplement their basic local service revenues when they serve these customers, they can serve these customers at a lower unit cost than other customers. For example, a CLEC that serves a customer, such as an ISP, that receives large volumes of one-way traffic will typically locate its switch in close proximity to that customer in order to minimize its transport costs. Because that customer does not originate any traffic, the CLEC need not worry about hauling traffic back to the originating LEC. Also, a CLEC can dedicate low-cost equipment to serve the needs of customers with large volumes of one-way traffic. For example, CLECs can use scaled-down switches or modem banks with SS7 capabilities to serve their ISP customers, thereby avoiding the costs of a typical local switch. In this respect, the arbitrage opportunity associated with high volume, one-way traffic, such as ISP-bound traffic, is accentuated.

The facts underscore the distorting effect of reciprocal compensation in telecommunications markets. As noted in our November 3 *ex parte,* CLECs "terminate" 18 times more traffic than

they originate, and 90% of the traffic for which CLECs bill reciprocal compensation is ISP-bound traffic. These numbers manifest a significant market dysfunction that can only be attributed to reciprocal compensation.

- *Under a bill and keep regime, carriers would have no greater incentive to serve customers that terminate traffic than customers that originate traffic. A LEC, like any other business entity, would recover its costs from its customers, and its business decisions would be based – not on regulatory arbitrage - but on the dictates of the marketplace, as Congress intended.*

2. Reciprocal Compensation Discourages Competition for Residential Consumers

While a reciprocal compensation regime gives CLECs strong incentives to pursue customers with large traffic imbalances, it reduces their incentive to serve residential consumers. The reasons are many. First, residential consumers do not, as a rule, receive more calls than they make, certainly not in large numbers. Thus, they do not generate large reciprocal compensation imbalances. Second, the provision of service to residential consumers diminishes the reciprocal compensation arbitrage opportunity that can be created by targeted customers with high volumes of incoming traffic and little or no outbound traffic. For example, a CLEC that serves an ISP would lose the reciprocal compensation revenues generated thereby if it also served the consumers who were the customers of that ISP. Third, the provision of service to residential consumers places CLECs at risk of having to pay large amounts of reciprocal compensation to other carriers. If one of those consumers, for example, accesses an ISP not served by the CLEC, the CLEC would be forced to pay reciprocal compensation to the LEC that is serving that ISP. Rather than forego the reciprocal compensation revenues and, worse yet, risk having to pay them, CLECs have incentives to avoid the residential market altogether.

- *Under a bill and keep regime, this disincentive to serve residential consumers would be eliminated. Carriers would not be able to net more reciprocal compensation by avoiding residential consumers, nor would they face the risk of having to pay significant amounts of reciprocal compensation if they served residential customers.*

3. Reciprocal Compensation Creates Artificial Disincentives to Invest in Advanced Services and More Efficient Technologies and is Thereby Inconsistent With Section 706 of the 1996 Act.

Using the circuit-switched network is an inefficient method of carrying data. Because reciprocal compensation is available only for traffic sent by an ILEC to a CLEC over the circuit-switched network, CLECs have a disincentive to provide Internet service in a more advanced and efficient manner. Not only does it create an artificial disincentive for CLECs to deploy xDSL services, it discourages deployment of <u>any</u> technology that would not generate reciprocal compensation.

Reciprocal compensation may also create disincentives for ISPs to deploy advanced services. While it is unclear the extent to which CLECs share their reciprocal compensation subsidy with their ISP customers, it is clear that CLECs have the ability to do so: because they recover the

full costs (and then some) of serving their ISP customers from reciprocal compensation, they can serve their ISP customers profitably even if they charge them little or nothing. To the extent that ISPs thereby receive below-cost dial-up service, ISPs are given an artificial incentive to rely on dial-up access in lieu of other, more efficient or more advanced forms of Internet access. In this respect, the availability of reciprocal compensation for ISP traffic is directly contrary to the 1996 Act's goal of encouraging the deployment of advanced capabilities.

- *Bill and keep eliminates this artificial disincentive to use dial-up instead of more efficient, more advanced Internet access capabilities. Indeed, because a bill and keep regime will promote market-based competition for the business of ISPs, bill and keep will give LECs incentives to provide the most efficient and advanced Internet access capabilities to their ISP customers. Bill and keep will thus promote the goals of section 706 of the Act.*

B. Reciprocal Compensation Co-Opts Real Competition in the Marketplace.

Because, for a number of reasons, including the distorting effects of reciprocal compensation, incumbent LECs serve the vast majority of residential customers, incumbent LECs receive little or no reciprocal compensation when they serve a customer, such as an ISP, with a large traffic imbalance. Consequently, when an incumbent LEC competes for the business of such customers, it must price its service in a way that permits it to recover all of its costs of serving that customer from the customer itself. This, of course, is as it should be. The problem is that the same rule does not apply to CLECs. When a CLEC competes for the business of an ISP or other customer with large volumes of incoming traffic, the CLEC can anticipate, not only the revenues it receives from that customer, but also large amounts of reciprocal compensation. The CLEC can draw on those anticipated reciprocal compensation revenues to undercut any competing bid by the incumbent LEC, which effectively co-opts true competition for that customer.

- *Under a bill and keep regime, all carriers will compete fairly and on the merits for the business of ISPs and other customers with large traffic imbalances. Success in the market will be dictated by the quality and price of their services, not the selective availability of a subsidy that can be used to defray costs. CLECs frequently claim that they have been successful in signing up ISPs because they can serve them more efficiently. If they can do so, they will continue to succeed in this marketplace, but for the right reasons – not because of regulatory arbitrage.*

C. Reciprocal Compensation Sends the Wrong Market Signals, Resulting in Inefficient Utilization of Telecommunications Networks.

1. Setting the Right Reciprocal Compensation Rate is Effectively Impossible.

Setting rates by regulation is always an inexact science. Setting an accurate reciprocal compensation rate is particularly problematic because the cost of terminating a call necessarily varies by carrier and by type of call. In addition, those costs will vary over time. Thus, unless reciprocal compensation rates are based on a continually updated showing by each carrier of its

actual costs of terminating different types of traffic, those rates will necessarily deviate from each carrier's actual costs.

This problem is exacerbated by regulatory interpretations of section 252(i) pursuant to which LECs may adopt the reciprocal compensation provisions of other interconnection agreements. That interpretation effectively allows any LEC to adopt the cost structure of another LEC, irrespective of whether that rate reflects its own costs.

The problem is further exacerbated by the failure of most regulators to distinguish properly among different types of traffic with different cost characteristics – most notably, ISP-bound traffic and local traffic.

Theoretically, it might be argued that, if the LEC that pays reciprocal compensation can recover its reciprocal compensation payments from its customers, then reciprocal compensation rates would be driven to efficient levels, as customers adjust their calling patterns to minimize reciprocal compensation charges. But that is not likely to happen because states are not apt to adopt minute-of-use rate structures for basic local calling. Moreover, the transaction costs of any pass-through system would be prohibitive in any event. LECs could not practicably charge different amounts for different calls based on the reciprocal compensation rate of the terminating LEC, nor would consumers have the information necessary to make informed decisions.

In short, the disciplining effects of the market cannot be harnessed. Reciprocal compensation will always be purely a matter of regulatory fiat. As such, it will always be inferior to a market-based approach, and it will require the very type of hands-on regulation that the 1996 Act was intended to displace.

- *Under a bill and keep regime, carriers that terminate calls will charge market-based rates for the termination functionality. There is no need for regulators to estimate termination costs.*

2. Per-minute reciprocal compensation rate structures are inherently inefficient.

Traffic termination costs are to a certain extent fixed. The Commission has long recognized that it is inefficient to recover fixed costs through usage sensitive charges, yet reciprocal compensation rates are predominantly based on minute-of-use charges. Thus, current reciprocal compensation rate structures recover termination costs in a manner that does not reflect the way those costs are incurred.

- *Bill and keep fixes the problem by displacing existing minute-of-use rate structures in favor of a market-based approach. Under bill and keep, carriers will compete for the business of customers that terminate traffic and the market will drive rate and rate structures to efficient levels..*

3. Reciprocal Compensation is Premised on the Erroneous Assumption that the Calling Party, but not the Called Party, Benefits From and Should Pay the Full Costs of a Call.

Reciprocal compensation is based on the erroneous assumption that the calling party derives all benefits from a call and should be required to pay all costs of the call. The reality is, though, that both the called and calling party benefit and should share the costs.

- *Under a bill and keep regime, the costs of the call would be shared by the calling and called party.*

4. A Reciprocal Compensation Regime for ISP-Bound Traffic Can Result in Inefficient Over-Utilization of Telecommunications Facilities.

To the extent reciprocal compensation applies to ISP-bound traffic, ISPs theoretically need not pay for the telecommunications they use to connect to their end users. At the same time, ISPs have incentives to keep their customers on-line for as long as possible in order to maximize advertising revenues and revenues from Internet commerce. In fact, ISPs sometimes encourage their customers to stay on-line even when they are not actually using the Internet. This causes network congestion and requires inefficient investment in new facilities to ameliorate that congestion.

- *Under a bill and keep regime, ISPs would not have unfettered incentives to generate artificial on-line minutes.*